DOW THEORY LETTERS INC.

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"Nothing created by man is so calculated to humiliate him as the stock market."

SUBSCRIPTIONS: With this mailing, subscriptions to this service have climbed to the highest level in the eighteen years that I have been in business. I know that many readers depend on these reports, some for basic direction, others for new ideas, and many simply to check their own conclusions against mine. Each week I receive comments, opinions and notations from all corners of the nation and the world. This information is invaluable and has been a great help to me in my work. I want to take this paragraph to thank all of you, to thank my silent readers as well, and to thank the powers above which have granted me any success I have had in this business over the years.

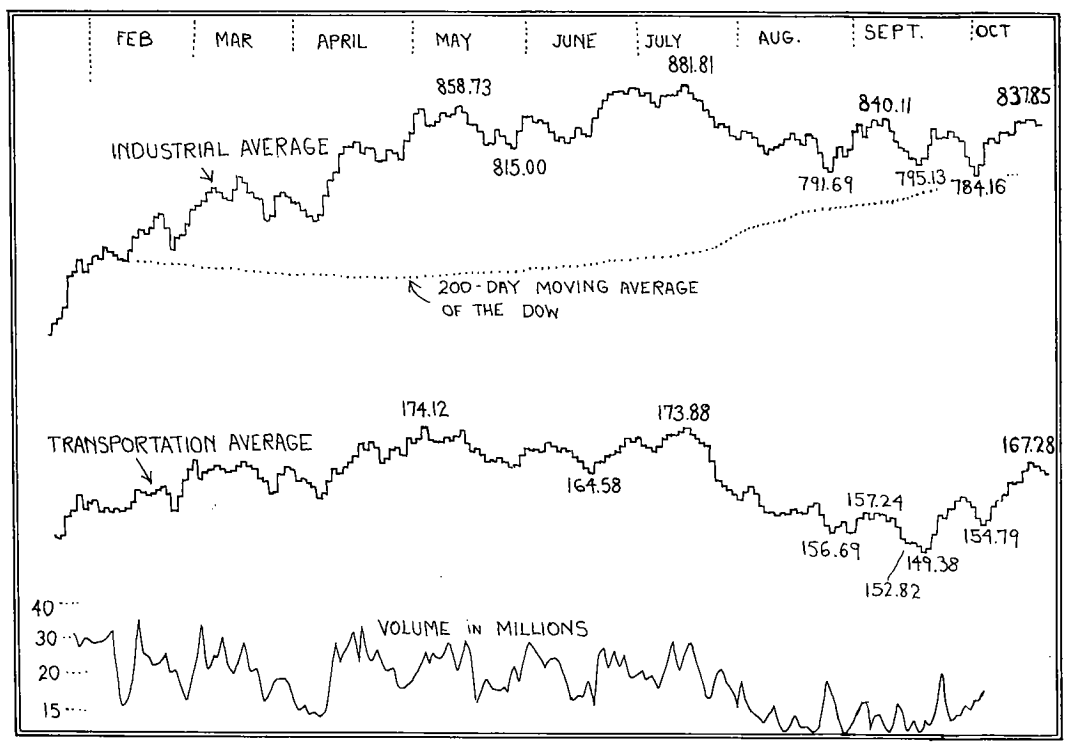
STOCK MARKET: The bull is getting to his feet again. Watch Industrials for a move above the September high of 840.11. Such a rise would confirm the recent Transport high above 160. If the Dow betters the 840.11 level, I believe we will see the beginning of a massive short squeeze as 24 million short sellers are forced against the wall, forced by the incoming tide of the primary bull market. Pushing above 840.11, the next levels to watch will be the 1975 recovery highs of 881.81 for Industrials, 174.12 for Transports.

MONEY MARKET: Interest rates are coming down as business remains sluggish, not poor — just sluggish. Watch for an across-the-board build-up in liquidity as corporations, cities, states, individuals, see the writing on the wall and begin putting their respective houses in order. The bond market is now basing for what could be a major swing to the bull side.

It's been a very long time since we've seen a primary bull market in both stocks and bonds. Most readers of these reports, in fact, have never seen such a situation. A bull market in stocks and bonds would constitute a bullish situation indeed. I believe it is about to happen.

ECONOMY AND THE MARKET: There will be trouble enough for business, but the stock and bond markets have discounted most of it. Any forthcoming "bad news" should serve to keep the public out of the markets for a while longer (the longer they stay out, the more extended the bull market). "Big money" continues to accumulate, and we could be witnessing the beginning of the third buying panic of 1975. All in all, I look for business in 1976 to be somewhat better than most people expect.

INFLATION: Under the pressure of a sagging commodity market, inflation should subside during the remainder of the year and into 1976. This will be taken bullishly by the Government and the public. The great commodity boom, in this writer's opinion, is over. A declining inflation rate and listless business will allow for a greater boost in the money supply (by the Fed) as well as lower interest rates.



BULL MARKET: The overriding technical consideration at any given time is the direction of the primary trend. I have been emphasizing and repeating that thesis for investors ever since I began writing this Letter in 1958. During a primary bull market (such as this one), we often get situations in which the market becomes "fat and sassy". There is too much enthusiasm, too much volume, too many amateur traders boasting about their paper profits, and too many fund managers con-

vinced that they are perfectly positioned. All this gives way to the bull market's version of humility, the secondary correction.

"Normally " a secondary correction in a bull market consumes three weeks to as many months, while retracing 1/3 to 2/3 of the preceding uncorrected advance. In view of that general description, how does the recent correction fit in? The correction started on May 5 and lasted to October. I use the May 5 date because that was the date of the last confirmed highs in the Averages (i.e., the point where both Averages recorded their last highs). In other words, the correction was roughly four months in duration.

How about the extent? The bull market began for the D-J Industrials at 577.60 on December 6, 1974. The 1975 high for the Dow Industrials occurred on July 14 at 881.81. That means that the entire bull market rise was 304 points. Then came the correction. The loss from the peak of 881.81 to the recent October 1 low of 784.16 was 97 Dow points. In all, the correction erased 31.9% of the entire 1974-75 bull market advance. In both duration and extent, the correction fits within normal bull market standards (although it was a little longer than average in duration, and a little shallower than average in extent).

Once a reaction in a primary bull market has ended, it is "buy time" for investors and traders. It is buy time because, by definition, if the correction is over, then in due time (regardless of bad news, poor earnings, scare headlines, acts of God), the Averages will push to new highs. The earlier it is in a bull market, the more certain that new highs lie ahead. The currect bull market is not yet a year old, so that there is reasonable certainty that new highs for the Averages and most stocks lie somewhere "just over the horizon".

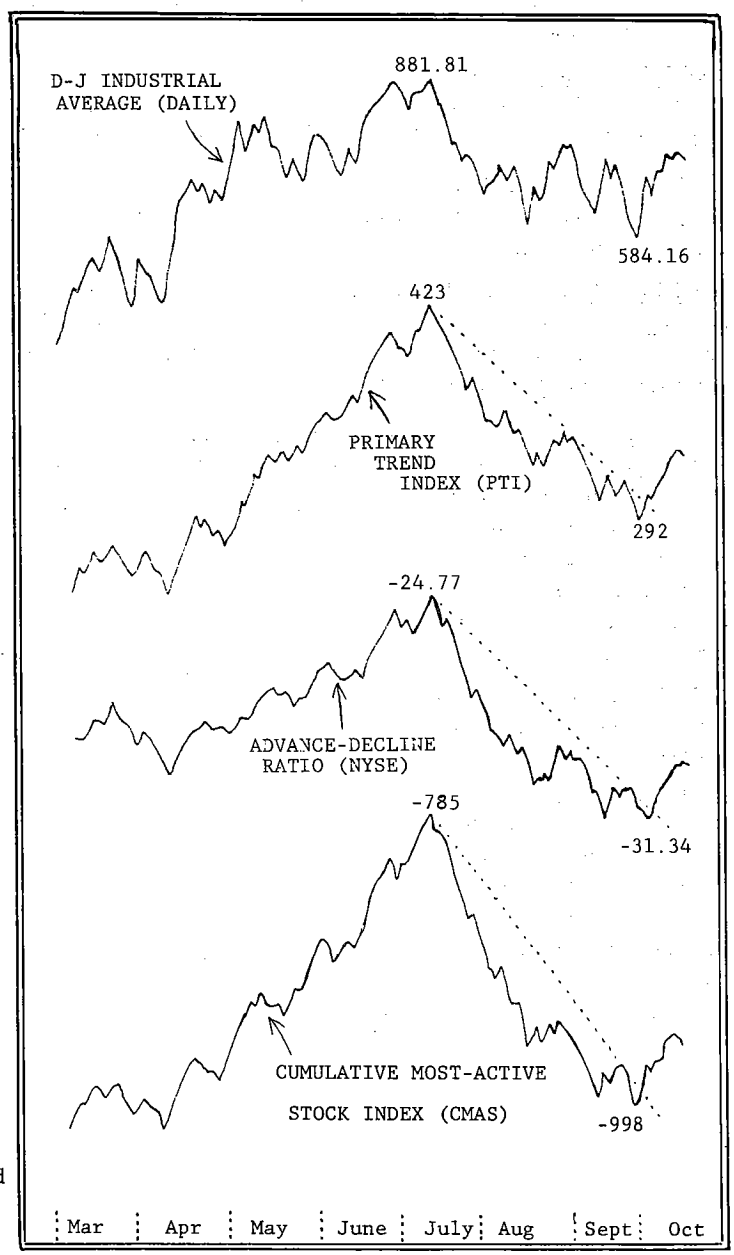
There are difficult and there are easy periods in which to write these reports, and, of course, the most difficult times occur when the market is hesitating or acting indecisive near an important juncture. In case you haven't guessed it, this is one of the very difficult times. Since I can't write the whole report an hour before printing time, it is sometimes necessary for me to write in terms of "ifs" and "buts" and alternatives. Often the fog will clear ten minutes before my press "closes". If that's the case this time, I will (as usual) put my final conclusion at the end of page 6.

I am writing much of this Letter in the midst of the NYC "cliffhanger". Actually, the market is acting quite well in the face of the impending catastrophe of a multi-million dollar default by the City. The Averages have stepped back to protect themselves, but in general I feel that the market is acting as if it has discounted everything but the City's breaking apart and slipping into the East River (with the West Side, naturally, falling into the Hudson River).

Odd-lot selling has been of monumental proportions as the public rushes for the exits in the face of what it sees as an historic fiasco. But I ask myself, "Who has been absorbing all the stock that the public is offering for sale? Why have the Averages rallied so far above their September-October lows when the NYC situation was so widely-advertised so many months in advance?" My own humble guess is that strong hands have been accumulating under the guise of the NYC disaster. A glance at the pattern of the Dow Industrials on the page 1 chart suggest, in fact, that a healthy dip in the Dow in this area would help to complete a pattern of a major market bottom.

My conclusion, therefore, is that following the fear selling that is now coming in (as the NYC situation goes to the wire), the market will take a downride stand — then push higher. Any forthcoming Dow closing above 840.11 would be an extraordinarily bullish event. It would, in my opinion, be the signal for an upside explosion on Wall Street.

In many ways the current situation is the most fascinating period of 1975. Almost all the major and widely followed Averages recorded their reaction lows on September 16. But the Dow Industrial Average dipped to its final (unconfirmed) low of 784.16 on October 1, eleven trading days later. Over the past two weeks almost all of the major Averages have bettered their August-September peaks, peaks which corresponded to the 840.11 (Sept. 8) peak for the Dow Industrials. The Dow alone has been the holdout.



Popular Averages which have now confirmed on the upside include the S & P 425 Industrial Average, the S & P 500 Stock Average, the NYSE Composite, the NYSE Industrial Index and the D-J 65 Stock Average. In the face of this almost unanimously bullish situation on the part of the other Averages and indicators, it is extraordinary that we have had so much resistance (to bettering 840.11) on the part of the Dow.

On August 14, 15 and again on the 16 the Dow did better the 840.11 level on an intra-day basis, but each time selling served to close the Industrials under the 840.11 mark. In past situations of this kind (wherein the majority of other Averages better a preceding point) the Dow does follow, and thus it will be most interesting to see whether history will repeat here at the 840.11 level on the Dow.

But I want to stress the following throught, and I would like subscribers to keep it clearly in mind. I feel that no matter what happens in NYC or anywhere else, the odds are heavily against a further downward extension of this reaction. By extension I mean a downward move which would take both Industrials and Transports to new correction lows (Industrials below 784.16, Transports below 149.38). This may seem to be small consolation, but remember, if a primary bull market refuses to record new lows in both Averages, then in due time the Averages will push through to new bull market highs.

We have a whole string of downside lows to watch during the "NYC crisis" weakness, and I personally doubt whether unforeseen or unexpected news will create selling pressure enough to break the September-October lows. On September 16 we had the following important low points: S & P 500 at 82.06, the D-J 65 at 238.96, the NYSE Composite at 43.59, the NYSE Industrials at 48.45, the S & P 425 Industraisl at 92.00.

We also have two money-sensitive Dow Averages to watch, and if these two indicators hold above these lows on any further weakness, it will add fuel to my thesis that the correction is over. The D-J Utility Average hit its low of 75.95 on September 16. The D-J 40-Bond Average recorded a low of 67.05 on October 3.

Next, we have the low point for the advance-decline ratio (see page 2 chart) which was recorded on October 1. There was also the low for the cumulative most-active stock index (CMAS) which occurred on October 1. Finally, the number of new daily lows for individual stocks is always a tell-tale indicator and an excellent gauge of the breadth of a decline. New individual stock lows were surprisingly sparse during the entire May-October correction, but the climax came with a reading of 33, recorded on the three successive days of September 17, 18 and 19 (based on my 5-day moving average of daily new lows).

Referring to the composite chart of the Dow and three key indicators (page 2), note that each of these indices has now bottomed out, each has broken above its July-October descending trendline, and each is heading higher. Moreover, it would appear that all three are in the process of forming powerful bases, although the basing action could conceivably take a while longer (often backing-and-filling action is necessary to complete a technical base).

I am particularly interested in the action of the advance-decline ratio at this time (this index gauges the advancing or declining tendencies of all the stocks listed on the NYSE). I am interested in the A-D because I believe the market could be moving into its third "buying stampede" of 1975. What is a buying stampede? It is a powerful, persistent series of upside market days which moves the A-D ratio up at least five points on a rising trendline basis. There is no better money-maker for the trader or investor than the buying stampede (as those of us who were in the market during December to May know).

Conclusion: Judging from a whole spectrum of technical measurement and indicators, it appears to me that the market established important lows during the period of mid-September to October, lows that should hold during any weakness that might appear in the period ahead.

And, of course, this whole discussion underscores one of the most important concepts in investing, which is that we always give greatest consideration to the primary trend. If, following a reaction, the lows in the Averages and the various indicators cannot and will not be broken, then the direction of the market is conceded to be up. That, in a nutshell, is where I believed we were when I wrote "Buy" in my last Letter. It is where I believe we are today.

Question: Russell, ever since July you've been talking about a correction that would carry into the fourth quarter of 1975, while taking the Dow down to perhaps the low 700's (or even below 700). Then in Letter 643 you turned cautiously bullish. In Letter 644 you turned out-and-out bullish and stated that the correction was over. But the Dow only got as low as 784. What happened to your projection of a Dow in the low 700's?

Answer: As I've noted many times before, they just don't run the market for Richard Russell. I wrote a few months ago that July tops during bull markets usually carry through to produce bottoms during October to December. Remembering this, the question then became, when, how and where would a fourth quarter bottom appear?

The Averages themselves will most often provide the answer to our market questions, so let's follow the daily action of the Averages as shown on the page 1 chart. In late-August the two Averages touched reaction lows of 791.69 and 156.69. We had a little rally, and then on the decline to the September 16 lows Industrials hit 795.13, Transport 152.82.

The 152.82 value represented a new reaction low for the Transports, but note that Industrials did not confirm. A second rally got underway, followed by a decline to September 16. Here Transports broke to a new low of 149.38, but Industrials would not con-

firm. A third rally got underway, and then a third decline. On the third decline Industrials broke to a new reaction low of 784.16, but this time it was the Transports that would not confirm. This whole series of downside non-confirmations denoted increasing resistance to further decline. When a correction in a primary bull market shows exhaustion characteristic on the downside — watch out! The bull is ready to take over again.

Simultaneously with the excellent action on the part of the Averages, the news of the day turned black. New York City was widely advertised as "going under," the State of NY was "sure to follow," the State of Illinois announced that it was insolvent and could not pay its bills, the British pound was near collapse, all hell, it seemed was breaking loose. Then a strange phenomenon occurred. Despite the universal "fear and trembling," the entire money market turned stronger. Most of my bond charts turned bullish, and it became obvious that the money markets were disagreeing violently with the rumors and gossip of doom. In such instances, I always go with the market itself.

The action in the stock market and in the money market was telling me that the time had come to make revisions on my "script." I took an arm full of charts down to the beach, sat in the sun, spread my charts out on the sand, and pondered for two hours. When I was finished I decided that the situation was strongly bullish and that I wanted to get Letter 644 out two days ahead of schedule. Letter 644 would contain my conclusions and my advice to "Buy."

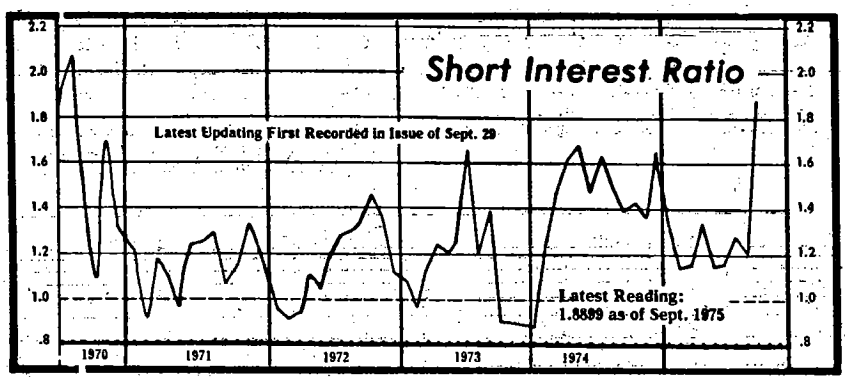
"All right, Russell," you retort, "but the low for the Dow came at 784. And you advised buying in Letters 643 and 644 when the Dow was up in the 810-830 area. That was 25 to 45 points off the Dow bottom." It's true, I didn't catch the extreme bottom, but then one of the things I guarantee to all subscribers of Dow Theory Letters is that I will never be perfect. In earlier Letters I had talked about "Dow 730 during the last quarter of 1975." What we got was Dow 784 during the last quarter of 1975. The timing was OK, the Dow level was off my projection by 50 points (however, the advance-decline ratio at this point shows that the majority of stocks are still at or near their reaction lows and thus in position for profitable buying).

About the matter of perfection — I might as well admit that during the first four or five years of my advisory career I suffered with the curse of perfectionism. I used to lay awake nights wondering whether this opinion or that statement was perfect. Then one morning I woke up realizing that the only perfection I had attained was this — I had devised the perfect method of driving myself crazy. Moreover, I realized that if I ever attained my goal of being perfect, my market service would be doomed, since I would soon sign up all the world's investors as subscribers, my readers would then break the NYSE (with my perfect advice), and I would shortly have to find a new business. Now all I offer is the best I am able. Subscribers who demand more are invited to try any or all of my excellent and able competitors.

QUESTION: In the last Letter you amazed me by talking about the Dow "at 1000 or 1100 by January, 1976". Were you serious or just trying to "push us" into the market?

ANSWER: I was serious. Remember, this is a primary bull market, the tide of Wall Street and the economy is up. Whenever a bull market is interrupted or held back for any reason (i.e., a correction, a panic, a news event), then technical strength builds up. It is like water in a stream being dammed up. The pressure builds, and the longer the water is held back, the greater the final "whoosh" when the dam gives way.

In the current situation, this bull market has been held back ever since May. The odd lot public turned increasingly bearish, and during the latest rally they have produced some fantastic selling figures of as high as 2.5 shares sold for every 1 purchased (thus they are jumping at the chance to sell shares on any market strength). When the market rallies or holds in the face of heavy odd lot selling, the inference is that stronger interests are purchasing (accumulating) while the public is dumping.



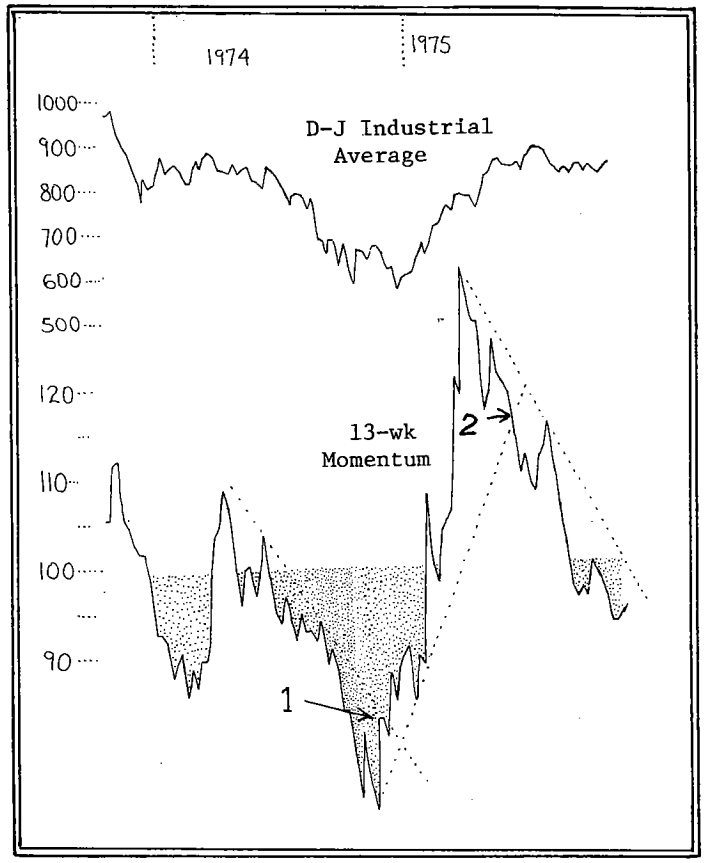
By the same token, the total short interest on the NYSE is now over 24 million, while the short interest ratio (ratio of total shorts to average daily volume) has risen to its highest and most bullish level in five years (see chart courtesy of M/G Financial Weekly).

The majority of investment services have stuck stubbornly with their opinion that the Dow and the market are heading into the basement in the low 700's or lower. The fact is that all Wall Street and most of the nation has been ready for the "final dive," the dive that was supposed to take the Dow down to the low-700's (many analysts have even predicted a smash below the bear market low of 584). So far, the market has not been willing to oblige.

It is well to remember that there is no more bullish a situation than during a primary bull market, following reaction lows, when the Averages begin to climb "the old wall of worry." That's the situation as I see it today. The technical condition of the market is strong, the money markets are bullish, the public is very fearful, the public is not prepared for (or it is actually fighting) higher prices, and the optimists are merely talking about a rise of the Dow to the "high 800's or maybe a little bit higher."

One of my favorite adages is this: "The market always does what is has to — to drive the greatest number of people out of their minds." I put this together with a sold-out market which is now rolling on the upside, and here's what I come up with. I come up with "the unexpected!" The unexpected, in my opinion, should be a major, powerful advance which could take the Dow over 1000. At any rate, that's the way I see it.

MOMENTUM AS A CRYSTAL BALL: My intermediate-term momentum index (chart on page 5) is based on the ratio of the current Dow Industrial value (Friday's close) and its close of 13 weeks ago. I attach particular significance to the Dow momentum at this time because momentum constitutes a lead indicator for the Dow and the Dow itself has proved (over the past few years) to be such an outstanding lead indicator for the entire market.



Note that the downward trend of momentum reversed itself (arrow #1) in November, 1974. This was one of the early signals for an end to the great bear market collapse of 1973-74. On May 16 the upward trend of momentum reversed itself to the downside (arrow #2), and this sounded the warning for the May-October correction.

The low for the 13-week momentum index was recorded during the weeks of September 26 and October 3, as you can see on the chart. Now this is where the study of the momentum index can become particularly helpful. The long descending trendline from the March high has been drawn in. I calculate that if the Dow can just remain above the 825 level, then by the end of this month the momentum index will not only move above 100, but the index will (at the end of October) reverse itself to the upside.

Positive momentum (which exists anytime the index is above 100) means that the Dow as of the Friday close is above its Friday close of 13 weeks ago. Negative momentum (shaded sections of the chart) exists when the index drops below 100, indicating that the Dow is below its reading of 13 weeks ago. It is particularly bullish when the Dow, following a period in the shaded section, pushes above a declining trendline line and then into the positive momentum area above 100.

For this reason, I am particularly interested to see whether the Dow holds its current gains (it doesn't even have to push up!), thereby positioning itself for a dramatic momentum breakout towards the end of October. A Dow reading of above 825 by the end of October would mean that the Dow momentum was reversing a seven month trend of declining momentum as well as moving back into positive momentum territory again (over 100) for the first time since last May.

Such a situation, occurring within a primary bull market, has extremely bullish connotations, and I therefore expect that the market will become strongly bullish during November and December and probably right into the first quarter of 1976.

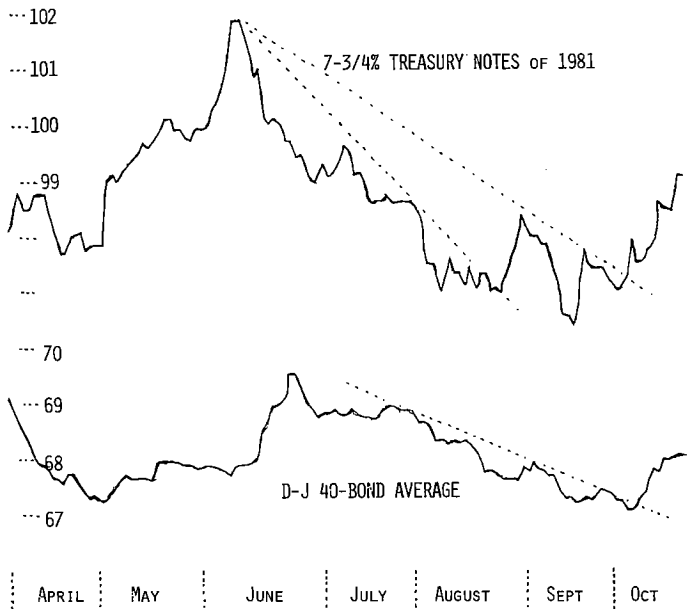
Question: Suppose the Dow heads up from here, and we get a bullish momentum signal before the end of October? Answer: That would be fine with me, but my point in this discussion is to show that the situation will turn very bullish even if the Dow simply stands still through the rest of October. In fact, I would prefer to see backing and filling and more fear during the remainder of this month. That kind of action would just add to the bullish undertone of the market, and it would keep the base technically strong.

Question: What are the implications of the momentum as far as buying stocks is concerned? Answer: Since Dow momentum is almost sure to turn bullish on a trend basis by the end of October, I would prefer that subscribers do any and all their buying of stocks during the next week or so (before Dow momentum turns bullish).

Question: Why, are you afraid we'll miss the boat? Answer: I would rather buy before the public and all Wall Street turns rampantly bullish. As long as the Dow is below its descending momentum trendline, I will consider that the bull market is in a base or buying area. Why not use our technical studies as timing aids? Remember, "if you're not sweating, you're not buying right." Technical analysis allows us to have the conviction to buy, even while we're still sweating!

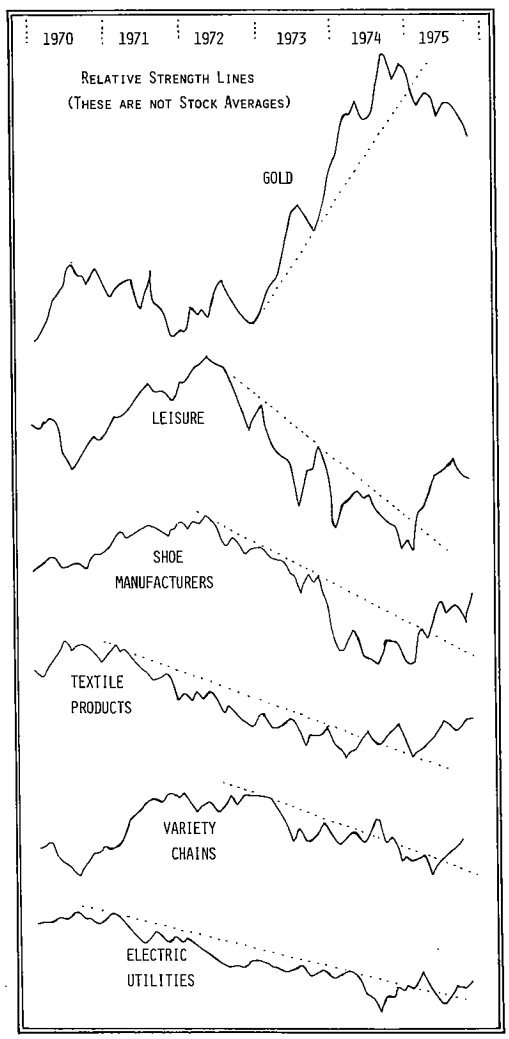
MONEY: The accompanying page 6 chart represents one of the most important indications in the current Wall Street equation. What we see here is a low in the Treasury notes during early September, a powerful base being formed, and the upside breakout occurring during October. On the broad D-J 40-Bond Average we see a 67.05 low on October 3, then a good rally which served to reverse the entire declining trend since mid-June.

I take this chart as a definite bullish omen for the money markets and for Wall Street. It is saying that in the face of the NYC mess, in the face of a reluctant Fed policy as far as easy money is concerned, the debt markets have bottomed out and are now heading higher.



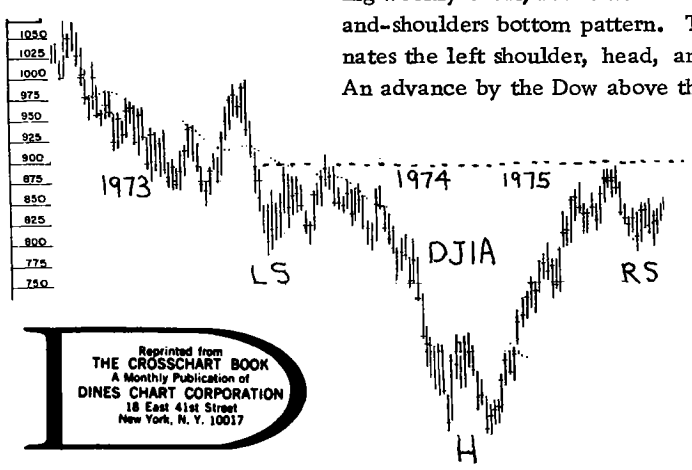
In the latest issue of the authoritative Bank Credit Analyst (1245 W. Sherbrooke St., Montreal 9, Canada), Editor Tony Boeckh lists some of the reasons why he believes (as I do) that the bond and money markets are heading bullishly higher. First, Tony notes that the period of intense US military involvements is over. Second, the "super-aggressive period of US (and overseas) banking is over," at least for the time being. Third, corporations have swung from an extremely adverse or negative condition of internal funds and investments to a positive condition (the first such swing since 1964!). A fourth plus for the bond market is the "growing strength of the US balance-of-payments and the dollar against foreign currencies." All of these forces, states Boeckh, should be strongly reinforced, "by the unprecedented degree of slack, by post-war standards, in the US and foreign goods and labor markets."

I know that in the face of the NYC crisis the concept of a bull market in bonds and money instruments seems positively ludicrous. Yet I believe we are on the edge of just such a bull market. Last week the 91-day T-bills broke below 6% for the first time since June, a development many observers considered impossible or imporbably. At the same time, broad strength came into many segments of the bond market with the D-J 40-Bond Average pushing over the 68 mark. I believe that any "prolonged" settlement of the NYC crisis would add the finishing touches on the bond market base. Then it would be a major rise for bonds, and that in turn would be a major plus for the stock market.



STOCKS: In recent reports I have recommended the closed-end bond funds and the closed-end stock funds. The accompanying chart shows relative strength indices for five stock groups. While often erratic, the gold group has been performing worse than the market since mid-1974, and it would be most unusual to have a major upside reversal this soon. The leisure group includes such stocks as Disney, Tandy and Outboard Marine, and Disney would be my choice here. In shoes we have Brown Group and Melville, and Brown is still interesting and very depressed. Textiles has Cone, Stevens, Burlington, Lowenstein and my choice here would be Lowenstein or Stevens. Variety Chains are turning up, and here it would be my oft-recommended Woolworth's. Electric Utilities were touched upon in the last report, and here you might check Carolina Power & Light and Central & South West as well as American Electric Power and Southern Company.

LATE NOTE: The longer-term pattern of the Dow Industrials (see accompanying weekly chart) has formed an immense head-and-shoulders bottom pattern. The chart designates the left shoulder, head, and right shoulder. An advance by the Dow above the 1975 high of 881.81 would send the senior Average above the resistance line (dotted line on chart), and complete the H & S bottom pattern. Above 881.81, we could see fireworks in the market, based on my interpretation of this chart.



Next Mailing: October 31.

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